CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

December 26, 2011

As the Year Winds Down

The European Central Bank has commenced a massive program to provide capital to banks. This mitigates the risk of a banking crisis over the next few months, and provides some support for new European government debt in this period.

Because we have pulled back from the abyss once again, because the risk of crisis has diminished, Core has made modest new investments.

A note of thanks. Before writing the next round of musings on the state of things political and economic, let me express the deep gratitude that we at Core feel for the opportunity you have given us to work for you. We thank you sincerely for the privilege of investing your capital on your behalf. The intellectual challenge offered by this remarkable and extended economic and financial crisis, now entering its fifth year, is stimulating and exciting. For better or for worse, 2012 promises more of this kind of challenge to investors: Euro-zone problems are still unfolding and the fraught election in the United States will provide more grist for our mill.

We enjoy greatly our work with you individually on specific personal financial matters and the exchanges we have with you over the course of the year. We hope that you are savoring the joys of life and family and friends at the year-end holidays. We wish you and your family a new year full of stimulation, good health, and good fun.

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And now, to matters European. In my gloomy letter of a few weeks ago, I wrote of the risks to investment assets from the Euro-zone crisis. Since then, short-term risks have receded because of actions of the European Central Bank (the ECB). As mentioned in that letter, leading central banks, the Federal Reserve, the ECB, and the central banks of the UK, Switzerland, Canada, and Japan, in early December announced a co-ordinated program by which the Fed would make unlimited amounts of dollars available in swap transactions with the ECB.

The next step in the process became known at the December 9 European summit meeting, when the ECB announced that it would extend the term of its lending to European banks in a program called the Long Term Refinancing Operation (LTRO), by which it would lend to banks at 1% for terms up to three years. On Wednesday the 21st, the ECB announced that it was lending €489 billion to 523 European banks in 17 countries. This massive bank funding effort will accomplish two things: (1) provide needed capital to banks at this time when their access to funding in private markets (e.g., US money market funds) has all but dried up, and (2) permit the banks to earn profits by investing this new, very inexpensive capital in sovereign debt issued by European countries. This in turn provides Italy, Spain, Belgium, France, Portugal and others potential buyers for the issuance of new debt in coming months on reasonably favorable terms. It is, in effect, a back-door way for the ECB to support the sovereign debt markets. Recall that the more

By

Jack Mayberry

direct approaches for the ECB to meet the liquidity needs of governments have been effectively vetoed by Germany.

From the Fed's playbook. This massive LTRO program recalls actions by the Fed in the aftermath of the Lehman bankruptcy in September 2008, when, through a series of radical new programs, the Fed and the US Treasury recapitalized US banks and restored the functioning of various credit markets. My expectation is that the ECB will continue the LTRO program and will introduce other new operations in coming months to maintain the functioning of the European banking system and the government bond markets.

While this operation does not end the Euro-zone crisis by any means, it does provide more time for the resolution of this complex matter. It lessens substantially the risk of a bank failure or similar event that could plunge the world back into financial crisis. For the time being, the LTRO provides needed liquidity for undercapitalized European banks and it lowers the cost of shorter-term European government borrowing. In the days following the ECB announcement, a series of auctions of sovereign debt with maturities up to a year or two were successfully concluded at low interest rates. Because the imminent danger has receded, Core has taken some modest steps to invest again in a more 'normal' way. We have used some of our large cash position to invest in an exchange traded fund that replicates an index of all tradable American bonds, treasuries, agencies, and corporates. We also added modestly to our US dollar position. If and as the situation in Europe stabilizes, we expect to make further investments.

LTRO does not solve the Euro-zone problems. While the ECB program may be an effective medium-term solution to bank capitalization and, perhaps, to government refinancing needs in coming months in Italy, Spain and other countries, it does nothing to restore the solvency of the indebted countries in Europe. Short-term *liquidity* is not the same as long-term *solvency*. The long-term solutions announced at the December 9 summit involve extraordinary fiscal austerity and, by my thinking, will necessarily depress economic activity. The troubled European countries desperately need economic growth; the German approach does not foster growth. The ECB action buys time for the complex fiscal and inter-governmental measures to be enacted. The essential problems of competitive imbalances between Germany and the rest and of the absence of economic growth remain unsolved. We will certainly be writing much more about all this for many months.

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CORE ASSET MANAGEMENT

PO Box 1629
108 Caledonia Street
Sausalito, California 94966
(415) 332-2000 • (800) 451-2240
fax (415) 332-2151
www.coreasset.com
info@coreasset.com